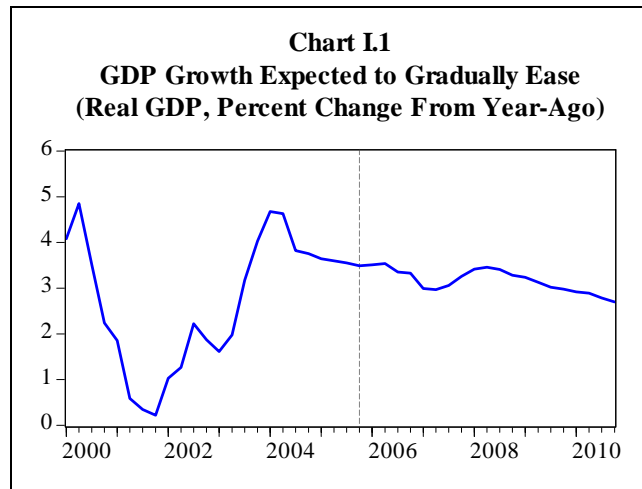


I. ECONOMIC OUTLOOK

U. S. OUTLOOK

The U.S. economy appears resilient in the face of the hurricane shocks, but high energy prices will dampen growth in the fourth quarter of 2005. That should be offset by faster growth in the first half of 2006 as reconstruction activity accelerates. Beneath the hurricane-induced swings, the underlying trend is slower economic growth, as the housing market cools and consumer spending growth eases. In the current forecast, Global Insight expects GDP growth of 3.6% in 2005, followed by 3.4% in 2006 and 3.1% in 2007.



The Forecast in Brief

The predominant picture emerging from recent data is of a resilient economy coping well with the hurricane shocks—although high energy costs are clearly hurting businesses and consumers. Indeed, high energy costs may have depressed the October payroll employment count (just 56,000 jobs added), and amplified an autos-led downturn in consumer spending. The storms will put a dent in fourth-quarter GDP growth as energy costs squeeze spending power, but growth should pick up in the first half of 2006 as reconstruction activity accelerates and energy production recovers.

The economy was carrying plenty of momentum when Katrina and Rita hit the Gulf Coast. Third-quarter GDP growth of 3.8% was strong, and would surely have exceeded 4.0% but for the hurricanes. The most recent Institute for Supply Management business confidence surveys are giving bullish signals, although they continue to emphasize the squeeze from high energy costs.

Businesses now seem a bit bolder about passing on their energy cost increases than earlier in the year, so it is welcome news that some energy prices have eased. The retreat of gasoline prices has come faster than most anticipated, and retail prices should now fall back to around \$2.25 by year-end. This will give consumers some needed relief, since the impact on winter heating bills from higher home heating oil and natural gas prices has yet to arrive—and will be large. Over the fourth quarter of 2005 and the first quarter of 2006, consumer energy prices will average about 20% higher than a year earlier, led by a 47% surge in natural gas prices. Energy costs will absorb 5.9% of disposable income over the winter months, up 0.7 percentage point from a year earlier.

Apparently, consumers are anticipating the looming winter heating shock, as consumer sentiment remained weak in October despite falling gasoline prices. Real consumer spending fell in both August and September, pulled downward by slumping auto sales. Indeed, vehicle sales plunged even lower in October, as high gasoline prices deepened the payback for the successful "employee discount programs." Real consumption is expected to slow to almost zero (0.1%) growth in the fourth quarter, although holiday sales will not be as bad as that looks, since vehicles take the biggest hit. Excluding light vehicles, real spending growth will reach 2.7%—tepid, but not disastrous.

Retailers usually judge the holiday season by year-over-year (y/y) nominal sales growth. On that basis, consumer spending (excluding autos and energy) is set to rise 5.4% y/y in the fourth quarter, more than a percentage point below the 6.7% rate in 2004, but roughly in line with 2003, and well above the depressed 2001 and 2002 growth rate rates of close to 3.0%.

GDP growth slows along with consumer spending in the fourth quarter, but only to 3.0%, as hurricane repairs and rebuilding gather pace, while auto inventories start to pile up again. By the first quarter of 2006, the positive stimulus from reconstruction combines with a recovery in energy production to pull GDP growth back to almost 4%. Thereafter, a gradual slowdown sets in, as the housing market cools in the face of overextended prices and higher interest rates. Even with an extra 150,000 housing starts over the next three years because of the hurricanes, starts should nevertheless fall back from their 2005 peak of more than 2 million units. Rapid price gains have made houses less affordable for the average buyer. Indeed, anecdotal reports and recent declines in new home sales suggest that some of the heat is beginning to leave the market.

In addition, consumer spending growth will be on a slowing trend. The personal saving rate has fallen below zero—for only the second time since World War II. This suggests that some rebuilding of savings is likely, especially if the home-equity pump from the housing market loses force.

In the business sector, corporations still have plenty of cash to fuel an expected double-digit jump in business equipment spending this year, and nearly the same next year. Still lagging behind, nonresidential construction spending should finally rebound during 2006, helped by post-hurricane rebuilding. Drilling activity will be boosted next year by still-high energy prices.

The hurricanes will bring to an end, at least temporarily, the improvement in federal government finances. Global Insight has added \$110 billion to federal spending over the next 3–4 years to cover hurricane-related costs. The budget deficit should accordingly widen to \$365 billion in fiscal 2006, from \$319 billion in fiscal 2005.

Export growth should reach the high single digits during the rest of 2005 and into 2006. There have been recent signs of economic improvement in the Eurozone and Japan, but not enough to keep U.S. export growth at the second quarter's double-digit pace. The dollar has appreciated this year based on a rising interest-rate differential in favor of U.S. assets, but its long-term path is still downward, due to the large and still-widening trade gap. The current-account deficit is likely to exceed \$900 billion (6.8% of GDP) in 2006.

The post-hurricane surge in energy prices sent CPI inflation soaring to 4.7% y/y in September, but there will be better news for October and November now that gasoline prices have fallen. The key question is what will happen to "core" inflation (excluding food and energy). Core inflation will likely rise as higher energy costs are passed through. The core rate is expected to creep up from 2.2% in 2005 to 2.4% in 2006. This suggests that more Federal Reserve tightening is required. Recent signals from the Fed continue to emphasize upside inflationary risks, rather than downside growth risks. As a result, the Fed will likely keep hiking interest rates a quarter percentage point at a time, reaching a 4.75% federal funds rate at the end of March 2006, before taking an extended pause.

Ten-year bond yields have moved above 4.5% on inflation nerves and the continued hawkish tone from the Federal Reserve. Yields should continue to rise, heading above 5.0% during 2006.

KEY FORECAST ASSUMPTIONS

The national forecast (prepared by Global Insight) in this report is based on several key assumptions which are outlined below.

Hurricane Damage and Response

The Bureau of Economic Analysis' (BEA) estimates of the damage from Katrina and Rita have been incorporated into this forecast. These imply \$76 billion in damage to the stock of private capital. U.S. private insurers will cover about \$35 billion in damage.

Another \$10 billion in damage from Hurricane Wilma in October (\$8 billion covered by private insurers) is now part of the forecast assumptions.

The federal government will spend \$110 billion in response to the storms, spread over several years. This represents \$80 billion in spending by FEMA (including \$20 billion in flood insurance) and \$30 billion in funding for infrastructure rebuilding. Global Insight has not assumed offsetting spending cuts.

Global Insight assumes an extra 150,000 housing starts over the next three to four years to replace units destroyed or rendered uninhabitable.

Corporate profits will take a sharp hit in the third quarter of 2005 due to destruction of corporate capital and insurance payouts. The BEA estimates the negative impact at an annualized \$151 billion. This is a one-time effect—so profits will bounce back sharply in the fourth quarter.

Oil prices (West Texas Intermediate) should be in the \$61–62/barrel range for rest of 2005, falling back gradually to \$55 by the fourth quarter of 2006. Prices will return to below \$50 during 2007 (dropping to \$42.50 by 2010). Today's high prices will lead to improvements in energy efficiency, restraining demand, and to increased exploration and development, producing extra supply. Neither mechanism works quickly, but they will eventually bring prices down. Global Insight assumes the retail gasoline price will retreat to around \$2.25/gallon by year-end, as margins over crude oil prices return to more-normal levels.

The hurricanes were a greater shock for natural gas than for crude oil. The key assumption here is that the Henry Hub price for natural gas will average \$11.99 per million Btu in the first quarter of 2006, 87% higher than a year earlier.

Other Key Forecast Assumptions

The Federal Reserve will make three more 25-basis point hikes in the federal funds rate, taking it to 4.75% as of March 28, 2006, followed by an extended pause.

Although the worsening U.S. current-account deficit implies that downside risks predominate for the greenback, it has strengthened against most currencies since the beginning of the year. This strengthening is assumed to reverse; the dollar will slide against the euro and yen over the rest of 2005, yielding rates of \$1.21/euro, 111 yen/dollar, and C\$1.17/dollar at year-end. Further dollar declines are anticipated against these major currencies, averaging 7% during 2006 and 5% during 2007. China began the process of renminbi revaluation with a small 2.1% move in July; future moves will be incremental. Over the next 12 months, the Chinese currency should appreciate another 5% against the dollar.

DETAILS OF THE U.S. OUTLOOK

Consumer Income and Spending

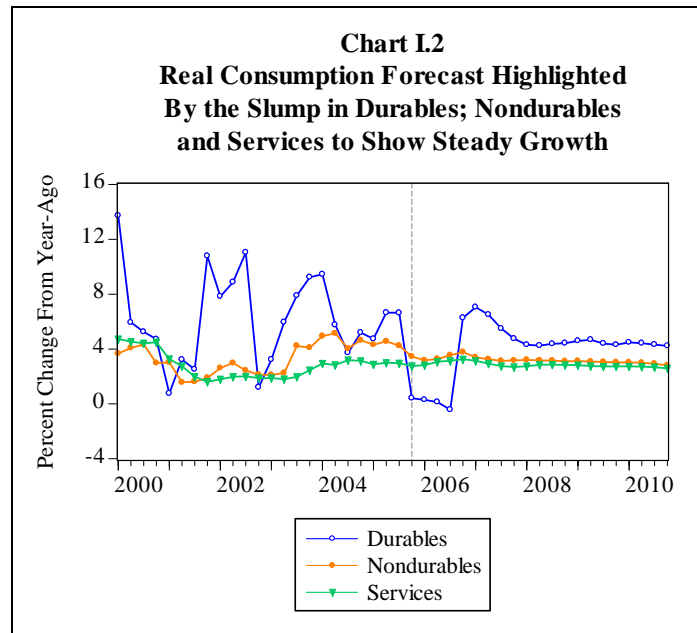
After 3.9% annualized growth in the third quarter, real consumer spending is projected to edge up at a miniscule 0.1% pace in the final quarter of 2005, its worst performance since a 0.3% decline in late 1991. The pause in growth is due to a sharp drop-off in light-vehicle sales following the successful "employee discount for everyone" sales campaigns of early summer. The surge in gasoline prices following Hurricane Katrina dealt a harsh blow to domestic automakers, as sales of gas-guzzling SUVs plummeted. The forecast anticipates that light-vehicle sales will drop from an annual rate of 17.9 million units in the third quarter to 15.7 million units in the fourth quarter, with light trucks accounting for most of the decline. The result could be even worse: light-vehicle sales fell to a seven-year low of 14.7 million in October, prompting automakers to sweeten incentives in mid-November. Better deals and a retreat in gasoline prices should spark a modest year-end recovery.

Annual light-vehicle sales are projected to decrease from 16.8 million units this year to 16.5 million in 2006, their lowest total since 1998. Rising interest rates, a cooling housing market, and a drop in home-equity cash-outs will restrain consumer spending on big-ticket items. Market saturation is another concern in the automotive market. From 2001 to 2005, the stock of vehicles has grown 2.2% annually, well ahead of the 1.2% growth of the driving-age population. With real incomes rising, light-vehicle sales should gradually recover after 2006, but it will be 2009 before total sales surpass their previous cyclical peak of 17.3 million units in 2000.

Excluding light vehicles, real consumer spending is projected to increase at a 2.7% annual rate in the fourth quarter, off slightly from the summer quarter's 3.1% pace. Despite the disruptions of hurricanes Katrina, Rita, and Wilma, the fall season is off to a strong start. Excluding autos and gasoline, retail sales increased a huge 1.1% in October, building on gains of 0.8% in both August and September. With the onset of colder weather, apparel sales were especially strong. As the holiday season begins, employment is rising, gasoline prices are quickly retreating, and consumer confidence is recovering. If core retail sales (excluding auto dealerships and gasoline stations) hold at their October level, this year's fourth-quarter sales gain will be a robust 7.2%—comparable to last year's and well above the 5.3% average over the past 10 years. It is unlikely that core retail sales will be sustained at October's pace, however, so the expectation for growth in the fourth quarter is 5.4% above the fourth quarter of 2004.

The average household energy bill will reach an annual rate of nearly \$4,800 this fall and winter, up 18% from a year earlier. Meanwhile, the share of household disposable income spent on energy will rise to 5.9%, the highest in two decades and 0.7 percentage point above its year-earlier level. As domestic refineries come back on-line and additional imports arrive, gasoline prices should drop to \$2.25/gallon by year-end. But natural gas prices will remain elevated through the winter months, running 53% above year-earlier levels in the January–March period. As the oil and gas supply situation improves over the next three years, prices will retreat and the share of disposable income spent on energy will decrease to 5.0% in 2007 and 4.3% in 2010.

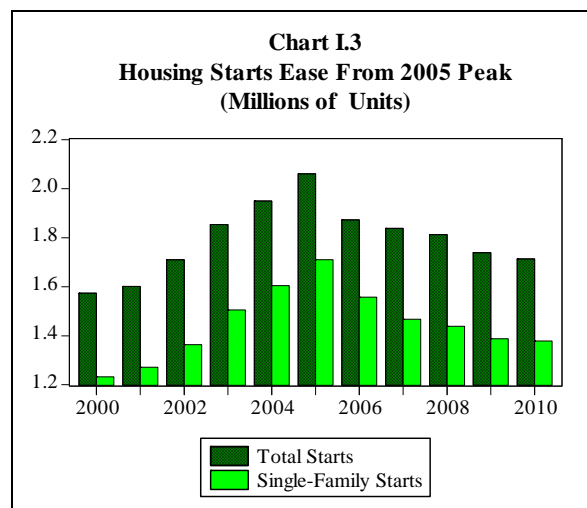
After gains of 3.9% in 2004 and 3.5% this year, real consumption growth will moderate to 3.0% in 2006 in response to rising interest rates and a cooling housing market. Growth in real household net worth will slow from 5.8% in 2005 to 2.8% next year, as home price appreciation subsides to its slowest pace in a decade.



Housing

Single-family starts are expected to set a new record during 2005. Single-family starts will soon reverse direction, however, falling 9.0% in 2006, 5.8% in 2007, and 2.0% in 2008. Starts will stabilize late in the decade. The mix of construction activity is expected to shift next year from housing to commercial and public structures.

While 1973 set the all-time record for total housing starts, this year's single-family starts total will blow away all prior records to claim the title. Single-family starts will reach 1.71 million, beating the 2004 tally by 6.6%. A chart showing single-family starts from 2003 to 2007 looks almost symmetrical, as the construction boom is expected to unravel at nearly the same speed at which it formed. Single-family starts totaled 1.51 million units in 2003, followed by 1.60 million in 2004; Global Insight expects 1.56 million in 2006 and 1.47 million in 2007. Single-family starts then average 1.40 million during 2008–10, more in line with the underlying demographic drivers.



Business Investment

Business fixed investment advanced 6.2% in the third quarter, its eighth consecutive quarterly gain, contributing 0.9 percentage point to real GDP growth. Spending on equipment and software (E&S) grew 8.9%, while nonresidential construction fell 1.4%. Spending on industrial equipment was particularly robust, posting a 20.5% surge, which offset its 18.9% drop in the second quarter. Industrial equipment has been posting good growth numbers since bottoming out in third-quarter 2003; the second-quarter drop appears to be an aberration caused partly by a plunge in engines and turbines, which had spiked in the first quarter. Global Insight expects a further string of positive-growth quarters for industrial equipment, with 8.0% gains projected for both the fourth quarter and 2006 overall.

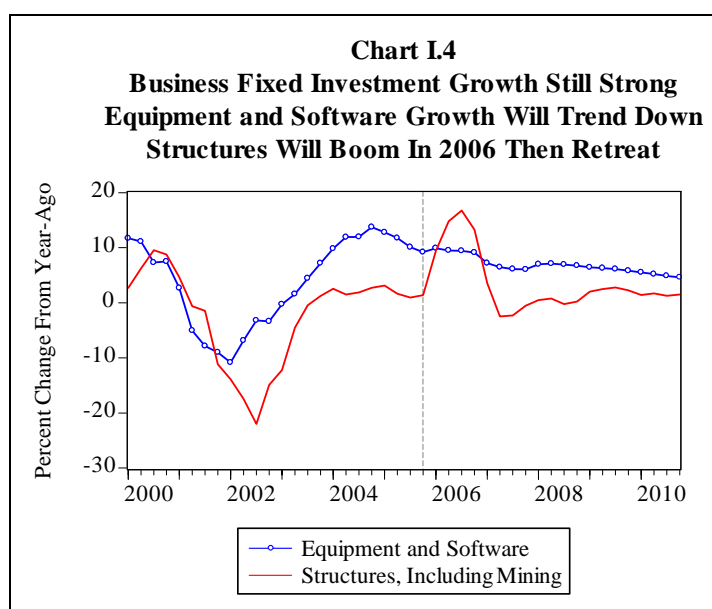
Spending on "other" equipment dropped 3.2% in the third quarter, after jumping 18.6% in the second, dragged down by weak spending on agricultural equipment, mining and oil-field machinery, and furniture and fixtures. Furniture and fixtures will rebound, while mining and oilfield equipment should post strong numbers because of high energy prices and repairs to rigs damaged by hurricanes Katrina and Rita. Growth from agricultural and construction machinery in 2006, though, is not expected.

Investment in software and communications equipment posted strong gains, yielding another strong quarter for information equipment. Real spending on computers grew 12.5%, but nominal spending declined. This decline is temporary, and computers should rebound smartly in the fourth quarter. Software should also continue to post solid gains. Information equipment has posted three consecutive double-digit quarterly gains, and the forecast calls for another one in the fourth quarter. Spending growth here is expected to be 13% in 2006, about the same as in 2004 and 2005.

Transportation equipment, dragged down by the Boeing strike, was flat in the third quarter. The latest word is that Boeing will make up lost production over several quarters, rather than over the next two quarters. The outlook for "other" transportation equipment has changed, based on a revised forecast for heavy duty truck deliveries. The fourth quarter should post strong spending on heavy duty trucks, despite sky-high diesel fuel prices. Next year, heavy truck sales will be greater than market fundamentals would indicate, because of looming EPA engine regulations that take effect in 2007. These regulations will spur sales in 2006, with the payback being a drop in 2007 sales.

In summary, equipment and software investment will continue to post steady growth. As a share of GDP, it is now 8%, its highest level since the fourth quarter of 2004.

For nonresidential construction, high energy prices and repair spending on hurricane-damaged rigs will drive the forecast for mines and wells. Spending here grows nearly 60% (annualized) in the first half of next year, but then starts to drop. So while spending on mines and wells rises 33% in 2006, it then drops 22% in 2007. The rest of nonresidential construction has stalled, mainly because of soaring input costs. Last year, surging steel prices dampened activity; prices for gypsum and cement and energy have taken a more recent toll. In the forecast, other nonresidential construction will get a small boost by reconstruction related to Katrina. In 2006, real spending on "buildings and other" grows 6.5%, while spending on public utilities climbs 9.0%. The numbers tail off after 2007, though, as the stimulus from hurricane reconstruction goes away.



Government

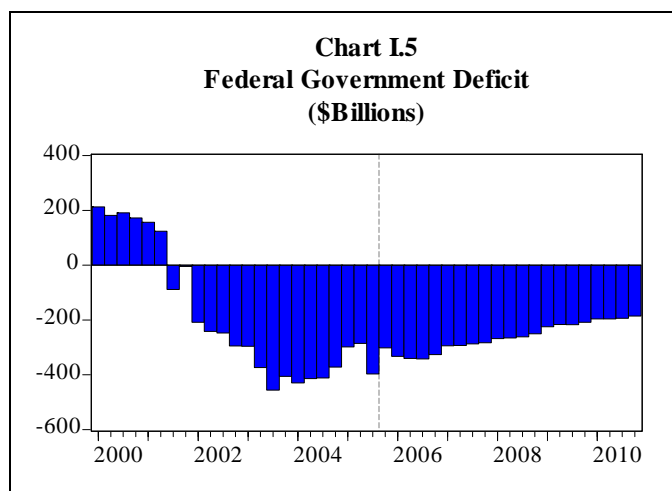
The Global Insight forecast for the unified federal deficit was bumped up about \$13 billion in fiscal 2006, to \$365 billion. This revision was connected with higher estimates of hurricane-related flood insurance payouts for fiscal 2006. No other change related to hurricane disaster relief or reconstruction was made to the spending assumptions. The flood insurance adjustment, however, lifted the cumulative costs of hurricane relief and reconstruction to \$110 billion in 2006–09.

When President Bush presented his 2006 budget in January 2005, his marching orders to Congress for long-term deficit reduction were relatively straightforward. In order to accommodate higher discretionary spending on defense and homeland security (a \$104 billion increment to the cumulative 2006–10 deficit), higher supplemental spending on the Iraq/Afghanistan wars (\$62 billion), extensions of the 2001 and 2003 tax acts (\$53 billion), and other savings and health insurance proposals (\$20.5 billion), Congress was charged with cutting \$138 billion in discretionary spending and \$68 billion in mandatory programs.

These goals were allocated across the various budget committees; however, by as early as March 2006, it became very clear that the fiscal 2005 deficit would wind up well below the White House projections of \$427 billion in January. The 2005 deficit turned out to be \$108 billion less than this target, almost entirely due to \$101 billion in higher tax revenues. With this much higher revenue base in 2005, the spending reductions required to hit the president's long-term deficit target in 2010 would be significantly lower. Despite this windfall, House-Senate budget committees had made little progress on key spending or tax bills by the summer of 2005.

The budget and tax reform processes were suddenly turned upside down when the August–September hurricanes hit, energy prices spiked, and avian flu hit the radar screen. As hurricane relief and reconstruction costs escalated, the budget ship went from slow to adrift, and by mid-November, the House budget committees had proposed about \$54 billion in spending reductions for 2006–10 as compared with the \$35 billion proposed by the Senate committees. With hurricane-related spending projected to bump emergency outlays nearly \$110 billion in the next four years, these proposals fell well short of what would have been required to keep the deficit under wraps and fund the extensions of the 2001–03 tax reductions.

The president's tax reform commission issued its final report on more comprehensive changes to simplify the tax code November 1. Although this package constitutes a bold, sweeping overhaul of the tax code, Congress is unlikely to consider dramatic changes to current tax laws in this current, highly partisan political climate. What appears to be emerging is a package of modest spending reductions in the next four years; however, these will likely not be enough to offset higher emergency spending levels in the short term. The inability to offset these will result in higher deficit projections for 2006–07, although deficits for these years will fall below what the president had posited in the January 2005 budget. Congress is expected to pass a short-term patch dealing with the expiration of the higher alternative minimum tax (AMT) exclusions at the end of 2005. Beyond that, Congress will punt, extending the 2001/03 tax acts; the tackling of more comprehensive tax reforms per the recommendations of the tax reform commission are likely to be deferred to 2006, when “calmer waters” will hopefully prevail.



International Trade

September's trade deficit surged to a record \$66.1 billion, with most of the month's unusual events yielding negative results. Exports fell \$2.8 billion, with aircraft and parts exports accounting for \$2.5 billion of the decline. Exports of cotton and chemicals slipped due to both port and production disruptions. Without hurricane- and strike-related disruptions, exports may have approached their August record. Imports rose by \$4.4 billion, with petroleum and the combination of electricity and natural gas each providing one-quarter of the increase. Consumer goods imports accounted for another 20%, but remained below prior peaks.

The September spike in the deficit should prove an aberration, although monthly shortfalls of more than \$60 billion are likely here to stay. Energy imports will remain high and even as oil prices recede, volume will replace price as a driver of nominal imports. And natural gas prices are still nearly 25% higher than their August levels. Better news is that aircraft exports not delivered during the Boeing strike will ship later, although making up for almost a month's output loss will take time.

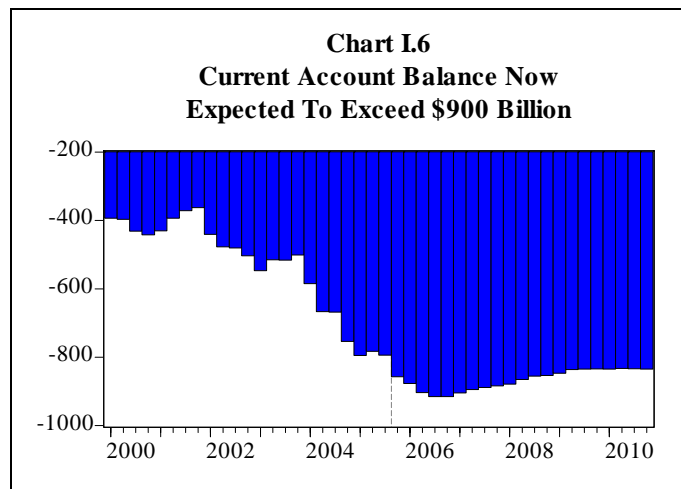
The advance release of third-quarter GDP data had net exports as a 0.1-percentage-point contributor to overall growth. However, actual September data (versus Bureau of Economic Analysis estimates) will ultimately wipe out those gains. Petroleum and non-oil industrial supplies were the sources of negative revisions.

Foreign trade will be a negative for GDP growth for the next year as rising imports of consumer goods, capital goods, and materials outweigh slow-but-steady export gains. Oscillating import growth requires an acceleration to get back in balance. Rising oil volumes do not help. And the strengthening of the

dollar against major trading partners' currencies does not help. Dollar weakness resumes in 2006, but from a higher starting point, leaving the currency stronger than a year earlier for much of next year. By 2007, cumulative weakness will leave the dollar 8.5% below its 2005 average; the decline reaches almost 12% in 2008, before the greenback stabilizes during the last two years of the forecast period.

Rising imports and sluggish exports should boost the real trade deficit until late 2006. The nominal trade balance will likely hit its nadir about the same time, but at higher levels than early 2005. The current-account deficit gets worse, reaching \$900 billion in 2006, up from \$807 billion in 2005. While some quarterly numbers will be worse, 2007 will be just a shade better than 2006. Progress on trimming the current-account shortfall accelerates in the final three years of the forecast period, with the 2008 deficit narrowing to \$860 billion; in the last two years of the decade, deficits average about \$835 billion.

Inventories are a buffer between production and sales; sustained periods of sluggish stock-building can trigger a catch-up phase in the inventory cycle. The next four quarters should be such a period. Retail inventory accumulation (excluding autos) was sluggish in mid-2005, averaging only half the speed of the prior two quarters. The next two quarters should see a recovery in stock-building toward the middle of those extremes. To accomplish this requires that import growth exceed sales growth; rebounding consumer demand will raise imports as well. For the next year, demand growth and inventory requirements reinforce each other, sucking in products from abroad.



Inflation

Short-term inflation concerns have been ameliorated in recent weeks, as crude oil and gasoline prices have decreased faster than originally anticipated. Natural gas prices remain high, however, with winter just ahead. In addition, strong third-quarter labor productivity growth, along with a decline in unit labor costs, have relieved some short-term inflation pressures.

The long-term inflation environment remains favorable for low core inflation rates as the Federal Reserve's "measured pace" of monetary tightening continues. Additionally, the Fed has set the stage for continued price stability with the nomination of Ben Bernanke, who is widely associated with the notion of inflation targeting, to succeed Chairman Greenspan as his final term ends on January 31.

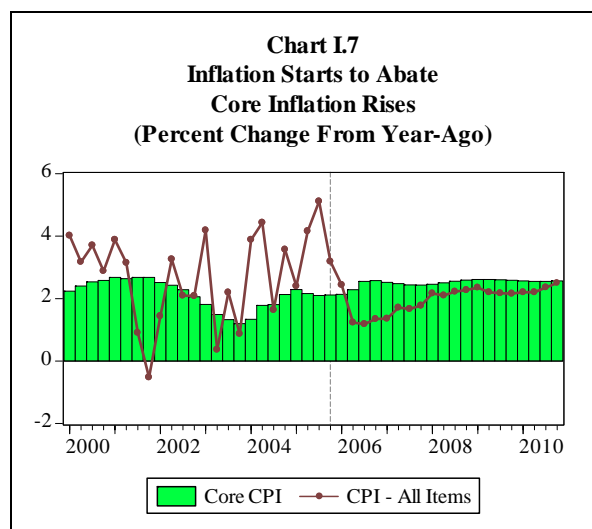
With energy price pressures abating, the head-line CPI inflation number is expected to run at an annual pace of 3.2% during the fourth quarter of 2005. The fourth-quarter outlook for CPI core inflation, which excludes energy and food price inflation, is expected to come in at a 2.4% annual rate.

The short-term alleviation in headline CPI inflation is good news for the longer term, as the risk of higher inflation expectations diminishes. Although, higher expected inflation in the present is not by itself a prophecy of higher future inflation, it does complicate life for the Fed as it tries to keep the inflation genie in the bottle.

Although the short-term cost environment has improved in recent weeks as energy prices have softened, there remains considerable cost pressure on CPI inflation from rapid advances in other input prices. After climbing at a seasonally adjusted annual rate of 2.5% in the third quarter, the current forecast calls for the producer price index for industrial commodities, excluding energy, to rise at a 7.6% rate in the fourth quarter and a 4.6% rate in the first quarter of 2006, before falling back over the rest of next year.

CPI inflation is expected at 3.4% in 2005, before falling to 2.6% in 2006. By comparison, CPI core inflation should run at 2.2% in 2005 and then edge a bit higher to 2.4% in 2006, just outside the Fed's 1.0–2.0% "comfort zone" in both years. By 2007, headline inflation drops to 1.5%, while CPI core inflation edges higher still to 2.5%, carrying with it some memory of the 2005 and early-2006 energy and crude materials price surge.

The long-term outlook remains favorable as monetary policy continues on a hawkish path. The Fed's statement following the November 1 meeting of the Federal Open Market Committee emphasized potential "inflation pressures" over the downside risks to growth. Moreover, as noted above, President Bush's nominee for Fed chairman has in the past advocated inflation targeting.



RISKS TO THE FORECAST

In addition to the baseline forecast just described, Global Insight provides two alternative forecast scenarios that can be viewed as more optimistic and more pessimistic outcomes relative to the baseline, but that also have a lower probability of occurring.

After several outstanding years, productivity growth has slowed, but will register a still-lively 2.5–3.0% rate in 2005. Can the U.S. economy sustain productivity growth rates this high for a long period of time? Many economists in academia believe that it can, and that the productivity boom may last another decade, if not longer. The optimistic scenario incorporates this view.

This alternative forecast also assumes no serious negative repercussions from the weaker dollar, and focuses on the momentum being created by the investment recovery. As the decade-long expansion of the 1990s showed, once an economy gets up a head of steam, it is difficult to slow it down. Indeed, the optimistic scenario resembles the late 1990s, when it seemed that the good times would last forever.

The optimistic assumptions produce a rosier outlook, with the U.S. economy growing 0.9 percentage point faster than in the baseline during both 2006 and 2007. Although economic growth and labor markets are stronger, inflation is lower because of the stronger dollar and the higher productivity gains. The lower inflation rate allows the Federal Reserve to keep the federal funds rate below the baseline value. Since productivity growth is stronger, potential GDP is higher and remains so throughout the forecast period. Job growth is also stronger. Nonfarm employment is 972,300 higher than in the baseline at the end of 2006 and 1.62 million higher at the end of 2007. Because job growth is strong, the unemployment rate stays below its baseline rate over the forecast period.

After a quarter-century of declining inflation, signs of a reacceleration are emerging. A doubling of oil prices, anemic domestic capacity expansion, a falling dollar, two-and-a-half years of accommodative monetary policy, and loose fiscal policy may have produced the conditions for a serious acceleration of inflation. The Federal Reserve is counting on continuing strong productivity gains, together with its "measured" tightening, to keep inflation at bay—but perhaps this is too sanguine a view.

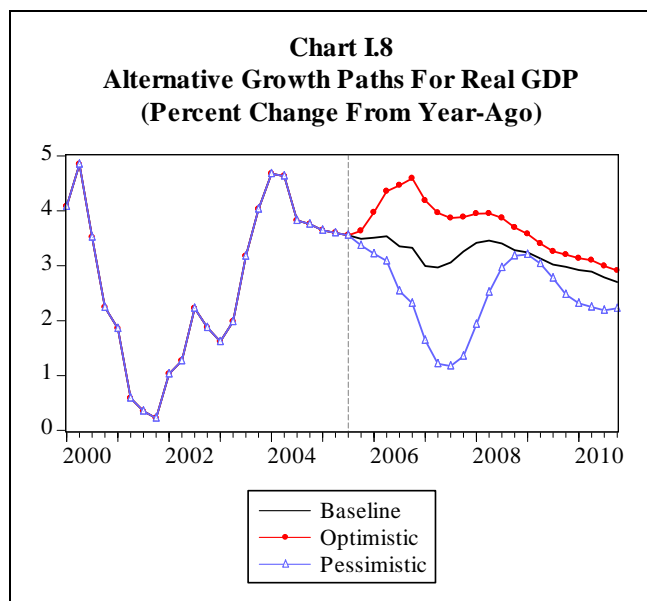
The pessimistic alternative assumes that there is less spare capacity than thought, both globally and in the U.S. economy. Rapid technological advances and high oil prices may have rendered obsolete much of the idled capacity that theoretically remains on the books. It assumes that the dollar weakens quickly as foreign investors take fright at the spiraling trade deficit, and thus lose confidence in the dollar. Interest rates rise as foreign investors diversify away from the dollar, and the federal deficit widens relative to the baseline. The falling dollar adds to the upward pressure on inflation.

In the baseline forecast, core inflation stays under 2.9% over the forecast period, allowing the Fed to slow the pace of interest rate hikes. In the pessimistic alternative, though, core inflation keeps gathering momentum, reaching 3.5% by the first quarter of 2006. The Fed responds by accelerating the pace of tightening. Despite the more aggressive stance, both the stock and bond markets slip on signs that the Fed may have let inflation build up an unstoppable momentum. The Fed cannot permit this acceleration to continue, and so it continues hiking interest rates. The federal funds rate averages 6.11% in the fourth quarter of 2006, compared with 4.75% in the baseline.

This simulation also has a housing price bubble that ends inauspiciously. The average price of existing single-family homes rises more than 15% above the baseline average by the first quarter of 2006, but then the bubble bursts. By early 2007, the average price tumbles more than 20% below its year-earlier value, and then stays below its base-line value throughout the forecast period. Housing starts tumble to 1.565 million units in 2007, compared with 1.838 million in the baseline forecast. Real spending on residential construction falls 7.2% in 2006 and 18.2% in 2007, compared with declines of 3.2% and 5.2% in the baseline.

Between the higher interest rates and persistently high energy prices, consumer confidence suffers. Consumers rein in discretionary spending and the U.S. economy slows. Core inflation stabilizes—but fails to retreat sufficiently, worrying the Federal Reserve. At the same time, hiring falters, causing the unemployment rate to climb. The Fed, forced to choose between fighting inflation and encouraging economic and employment growth, focuses on the long-term consequences of its policy and chooses to battle inflation—and, in fact, inflation eventually tapers off. Debt-laden consumers retrench further. Finally, early in 2008, with the unemployment rate near 6.00% and the federal funds rate at 7.75%, the Fed decides to hold. With the weaker dollar boosting trade, GDP growth begins to accelerate, bringing the unemployment rate down. As investment activity picks up, potential output increases relative to actual output, easing the upward pressure on prices.

The economy does not sink into recession in the pessimistic alternative, but merely fails to come as close to its potential as in the baseline, with GDP growth coming in 0.6 percentage point below the baseline rate in 2006 and 1.8 percentage points below the baseline in 2007. Production shifts from satisfying domestic demand to serving foreign demand, which responds strongly to the weaker dollar. The ground lost relative to the baseline is never made up, though, and real GDP is more than 5.0% below its baseline level at the end of 2015.



A summary of the U.S. forecast is contained in Appendix 1.